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An Essay Inquiry: Will the JOBS Act's Transformative Regulatory Regime for Equity Offerings Cost Investment Bankers' Jobs?

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AN ESSAY INQUIRY: WILL THE JOBS ACT'S TRANSFORMATIVE REGULATORY REGIME FOR EQUITY OFFERINGS COST INVESTMENT BANKERS' JOBS?

By: Kurtis Urien and David Groshoff***

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ABSTRACT

This jointly authored Article scaffolds our respective research interests that analyze laws, rules, regulations, and policy levers that may inhibit—or exploit—a market’s ability to recognize an asset’s intrinsic value, whether in terms of social, human, or financial capital.

In particular, this Article describes recent material changes to the Securities and Exchange Commission (SEC) rules promulgated in 2013 that Congress authorized by passing 2012’s JOBS Act. Contrary to statutory timing, the SEC has delayed the implementation of these new rules that impact the ability of small and entrepreneurial businesses to attract equity capital financing via Internet platforms. By applying the Court’s historical tests for public equity offerings to the new regulatory regime, this Article analyzes what types of equity-securities offerings ought to be permitted under the new regulatory regime. This Article, however, also illustrates numerous material shortcomings of the JOBS Act and articulates the reasons underpinning those shortcomings and how they affect the U.S. economy, entrepreneurship, and job creation, thus undermining much of the purpose of the JOBS Act.

To address these deficiencies, this Article suggests several proscriptive amendments to the JOBS Act that not only would enhance equity crowdfunding for small businesses and entrepreneurs, leading to job growth in the U.S., but also preserve investor protection. This Article concludes that the current regulatory regime may very well fail not only to create jobs by crowdfunded equity financing of new businesses sought by the JOBS Act but also eliminate the jobs of the traditional equity financiers—investment banks—thereby leading to a potential equity capital crunch and a reduction, rather than an increase, in employment relative to equity financing.

I. INTRODUCTION

Every business begins somewhere, sometimes from an idea that sprouted in an entrepreneurial dreamer’s mind, and sometimes, post-bankruptcy closing, from some other beginning’s end.¹ The boundaries of what newly formed businesses may achieve in terms of operation and growth remain nearly as limitless as the human imagination and the laws, rules, and regulations that prohibit that imagination from becoming reality. However, additional barriers exist to each business’s formation or operation, from obtaining formation capital, to property, plant, or equipment.²

Historically, the material methods that entrepreneurs employed to obtain start-up capital are through equity investment, debt, or a combination of both. Financial capital is not cheap.³ To obtain an accurate calculation of the cost of capital, entrepreneurs typically need to hire

1. SEMISONIC, *Closing Time*, on FEELING STRANGELY FINE (MCA Records 1998).

2. See Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998).

3. See John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 869 (2005).

an accountant to calculate that cost, measured by the weighted average cost of capital.⁴

Entrepreneurs have faced the difficulty of obtaining capital for a long time. However, with the advent of the World Wide Web and exponential use of the Internet, the world is much more interconnected than the world was in the 1930s. The ability to access information and communicate with one another is unlimited. Before the Internet's invention, if an organization wanted to raise money for donations to support a charity, that organization would have to seek those donations by means of face-to-face communications, solicitations through mail, or advertisements via television or print media. Face-to-face communications are effective and inexpensive, but do not reach very many people.⁵ Solicitations through U.S. mail reach many people, but are ineffective because few people read impersonal correspondence received via U.S. mail.⁶ Advertisements reach many people but are expensive and are only effective if the advertisement includes Sarah McLachlan singing about puppies and kittens.⁷

With the Internet, that same organization can reach millions of people, with lower costs, and be effective at the same time. Recently,

4. The Weighted Average Cost of Capital (WACC) measures the expected cost for the company's various obligations including debt, preferred stock, and common stock. WACC is an important tool for the company in determining whether a proposed project by the company will be profitable. As long as the WACC of a project is less than the expected returns of the project, discounted to the present, the project will provide a return to the company. Such projects will increase the company's free cash flow and should increase the intrinsic value of the company's stock and subsequent market price. Using external capital to fund company projects and investments rather than internal free cash flows that result from returns that exceed WACC because the company must either pay interest or dividends on the outside capital. Such frictional costs do not exist in preferred equity financing since preferred stock is generally sold from corporation to corporation. But if the company sells preferred stock or debt instruments such as bonds via an underwriter, these friction costs still exist. *See generally* EUGENE F. BRIGHAM & JOEL F. HOUSTON, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 337 (13th ed. 2012).

For a further humorous explanation of WACC, see Amarathe, *Baby Got WACC*, YOUTUBE (Apr. 20, 2007), <http://www.youtube.com/watch?v=JluzYxAexvg>.

5. Judy Lightfoot, *In-Your-Face Solicitations on Downtown Streets*, CROSSCUT.COM (Aug. 11, 2011), <http://crosscut.com/2011/08/11/business/21193/Inyourface-solicitations-on-downtown-streets/>.

6. To improve the effectiveness of U.S. mail solicitations, it is recommended that one compile a mailing list that singles out responders. *See generally* Jerry Mamola, *Mailing Lists 101: What Every Media Buyer Needs to Know*, <http://www.listsformarket.com> (last visited Dec 18, 2013); *see also* Digital Direct, *Seven Steps to Effective Direct Mail*, <http://www.msp-pgh.com/files/7-Steps-to-Effective-Direct-Mail.pdf> (last visited Dec. 18, 2013).

7. *See* Stephanie Strom, *Ad Featuring Singer Proves Bonanza for A.S.P.C.A.*, N.Y. TIMES, Dec. 25, 2008, http://www.nytimes.com/2008/12/26/us/26charity.html?_r=0; Sarah McLachlan *SPCA Commercial*, YOUTUBE (Nov. 26, 2008), <http://www.youtube.com/watch?v=IO9d2PpP7tQ>; *The Most Effective Fundraising Channels for Soliciting Donations*, REDBIRD (Nov. 30, 2012), <http://www.redbirdonline.com/blog/most-effective-fundraising-channels-soliciting-donations>.

theCHIVE.com⁸ attempted to raise money to support the Stein family of Missouri, the family of a sick child who needed custom additions and renovations to the family's house to accommodate the child's disabilities.⁹ TheCHIVE.com created a funding portal on gofundme.com where altruistic individuals could donate however much money they chose to provide to the Stein family to help obtain the much needed renovations.¹⁰ TheCHIVE.com's goal was to raise \$30,000.¹¹ Within three days and as of May 7, 2013, supporters had donated over \$160,000.¹²

TheCHIVE.com's ability to raise capital is a microcosmal example of the kind of capital that foundations and/or business enterprises can raise via the Internet. The supporters of the Stein family received nothing in return for their contributions; their only motivating factors were goodwill and the desire to help a family in need. Imagine how much money could be raised if, instead of getting nothing in return, supporters could receive some kind of tangible or measurable benefit in return?

Other illustrations include the projects funded on websites such as kickstarter.com. On kickstarter.com, individuals can fund projects such as documentaries, television shows, and even major motion pictures.¹³ In exchange and in return for their money supporting the film or project, the supporter receives incentives such as memorabilia, screenings, invitations to parties with cast members, and copies of the sound track.¹⁴ Supporters essentially purchase consumable goods or services, or both, in the form of perquisites related to the project. When the costs of these perquisites are less than their corresponding sale price, the excess or residual goes to fund the project. The most recent kickstarter.com campaign to hit the headlines was the funding of a Veronica Mars movie in which the campaign raised over \$5.7 million.¹⁵ One might imagine how much money could be raised if, instead of receiving soundtracks and advanced screening tickets, these supporters could be guaranteed a recoupment of their donation or investment plus a reasonable rate of return.

The foregoing atmosphere reflects crowdfunding. Congress broadly defined crowdfunding in the Jumpstart Our Business Startups Act of

8. This website is self-proclaimed as "probably the best website in the world."

9. John Resig, *An Unbelievable Griffin Stein Update*, THECHIVE.COM (May 3, 2013), <http://thehive.com/2013/05/03/an-unbelievable-griffin-stein-update/>.

10. GOFUNDME, <http://www.gofundme.com/2pb2cg> (last visited May 16, 2013).

11. Resig, *supra* note 9.

12. *Id.*

13. KICKSTARTER, <http://www.kickstarter.com/start> (last visited May 16, 2013).

14. Zach Braff, *Wish I was Here*, KICKSTARTER, <http://www.kickstarter.com/projects/1869987317/wish-i-was-here-1> (last visited May 16, 2013).

15. Rob Thomas, *The Veronica Mars Movie Project*, KICKSTARTER, <http://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project> (last visited May 16, 2013).

2012 (JOBS Act) as “Capital Raising Online.”¹⁶ Tanya Prive of Forbes Magazine defined crowdfunding as “the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.”¹⁷ Crowdfunding potentially helps solve problems of difficulty of obtaining capital and the associated cost of obtaining that capital that an entrepreneur faces. Raising capital online so far appears to be relatively simple, effective, inexpensive, and capable of reaching millions of potential investors.¹⁸ Crowdfunding as a means of obtaining capital really is nontraditional, since that method appears to represent a manner of raising capital that is better suited to the current era than traditional equity and debt investment mechanisms.¹⁹

A problem exists, however, if an entrepreneur raised capital online in exchange for equity ownership of the startup; then that entrepreneur may have issued securities subject to regulation under the 1933 Act and would face civil penalties for not complying with federal securities laws, rules, and regulations.²⁰ To facilitate equity crowdfunding and avoid some of the hardships of the federal securities laws, Congress, in 2012, passed the JOBS Act.²¹ However, Congress may have created more problems for entrepreneurs and potential investors than Congress solved with the JOBS Act. As a result, this essay will highlight some of the shortcomings of the JOBS Act and provide alternative solutions that, if implemented, could eliminate traditional investment banks’ essential role as part of the initial public offering (IPO) dealmaking process.

Part II discusses the difficulties facing startups in obtaining capital. Part III describes crowdfunding and its brief history. Part IV analyzes whether equity crowdfunding creates a security that falls within the scope of the federal securities laws, rules, and regulations. Since this Article concludes that equity crowdfunding falls within the scope of the federal securities laws, rules, and regulations, Part V discusses what compliance with federal securities laws, rules, and regulations

16. See Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 301, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

17. Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012, 10:50 AM), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/>.

18. Jenna Wortham, *Success of Crowdfunding Puts Pressure on Entrepreneurs*, N.Y. TIMES, Sept. 17, 2012, at B1, available at <http://www.nytimes.com/2012/09/18/technology/success-of-crowdfunding-puts-pressure-on-entrepreneurs.html?pagewanted=all>.

19. See Gary Emmanuel, *5 Reasons Why Equity-Based Crowdfunding Under the JOBS Act Won't Work*, HUFFPOST BUS. (Feb. 25, 2013, 12:41 PM), http://www.huffingtonpost.com/gary-emmanuel/5-reasons-why-equitybased_b_2759580.html.

20. See Prive, *supra* note 17; C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 11 (2012).

21. See Prive, *supra* note 17.

looks like for crowdfunding and how the JOBS Act has exempted crowdfunding from certain requirements. Part VI depicts some of the shortcomings of the JOBS Act, and Part VII provides alternatives to the JOBS Act that may overcome the JOBS Act's shortcomings. This Article concludes that through an effective implementation of crowdfunding, funding portals could replace underwriters in offering securities to the public, causing underwriters to lose their jobs to funding portals.

II. DIFFICULTIES OBTAINING CAPITAL

A. Debt financing

1. Cost of Debt

Obtaining capital through debt is not an easy task for the entrepreneur.²² Nevertheless, loans are the primary source of capital for small businesses.²³ The primary sources of business loans are commercial lending institutions or banks.²⁴ A lender generally operates with the predominant purpose of making money for the lender's shareholders.²⁵ Lenders require borrowers to pay the lenders for the opportunity to borrow capital. When a lender lends capital to the entrepreneur, the entrepreneur is essentially renting the money from the bank, and the bank requires that the entrepreneur pay rent in the form of interest on the loan.²⁶ Interest rates vary depending on a calculation of various market and risk factors.²⁷ Generally, the interest rate a bank gives to an entrepreneur will be high due to the risk asso-

22. William Alden, *Small Businesses Still Having Trouble Getting Loans*, HUFFPOST BUS. (May 25, 2011, 7:30 PM) http://www.huffingtonpost.com/2011/02/09/small-business-loans_n_820675.html.

23. Fisch, *supra* note 2, at 60.

24. See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 222 (2002) (discussing the homogenization and consolidation of United States banks).

25. *Id.* at 288.

26. Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 603 (2000).

27. The interest rate (k) that a business gets is typically the sum of the interest rate of the corresponding risk free security (rf) (generally the rate of the treasury bond that has the same life as the debt obligation), an inflation premium (ip) (generally calculated by the average of the current inflation rate and the expected inflation rate for the life of the debt), a liquidity premium (lp) (a premium that represents the risk of making an illiquid asset), a maturity risk premium (mrp) (a premium that compensates the lender for the risk that the loan will not mature upon the ending of the life of the loan), and a default risk premium (drp) (determined by the borrower's credit rating) ($k=rf+ip+lp+mrp+drp$). See generally BRIGHAM & HOUSTON, *supra* note 4, at 189–94; but see Jennifer F. Bender, *The Average Interest Rate for Small Business Loans*, CHRON.COM (2013), <http://smallbusiness.chron.com/average-interest-rate-small-business-loans-15342.html>.

ciated with a brand new business organization.²⁸ The cost of debt financing can therefore be formidable. The only saving grace is that interest payments are often deductible from federal income taxes.²⁹

2. Finding a Willing Lender

Not only is debt expensive, finding a lender willing to issue a loan or extend a revolving line of credit is not easy.³⁰ Especially right now with interest rates as low as they are, banks have become less likely to loan money.³¹ Typically, lenders are only willing to extend credit or issue a loan if the debtor has property that the debtor can use to secure the obligation as collateral.³² The entrepreneur secures the obligation by granting the lender a security interest in the business's personal or real property, or both, as collateral.³³ If the entrepreneur conducts business as a sole proprietor and grants a security interest in the business's property, then the entrepreneur essentially grants a security interest in the entrepreneur's own property, since the sole proprietor invests personal assets into the startup.³⁴ Once the obligation is secured, if the entrepreneur defaults on the obligation, the lender can foreclose on, or take possession of, that collateral.³⁵ Being subject to the loss of one's property is another risk that the entrepreneur faces.

B. Equity Financing

1. Cost of Equity

Instead of choosing to employ debt financing, the entrepreneur can obtain capital from investors who, in exchange for their investment in the startup, take an equity or ownership interest in the startup.³⁶ Obtaining equity financing, just like debt financing, is not easy.³⁷ Invest-

28. *Small Business Rate Report*, BLOOMBERG BUSINESSWEEK (May 17, 2013), http://www.businessweek.com/smallbiz/resources/rate_report/sb_rate_report.htm.

29. See generally 26 U.S.C. §§ 161–163 (2012) (federal tax code provisions allowing deductions for ordinary and necessary expenses paid or incurred in carrying on a trade or business and interest payments on loans).

30. Wilmarth, *supra* note 24, at 228.

31. See generally Alden, *supra* note 22; *Small Business Rate Report*, *supra* note 28.

32. See Wilmarth, *supra* note 24, at 230; SBA.GOV, <http://www.sba.gov/content/collateral> (last visited May 16, 2013).

33. U.C.C. § 9-203 (1998) (stating the requirements to grant a security interest in personal property).

34. Mitchell F. Crusto, *Unconscious Classism: Entity Equality for Sole Proprietors*, 11 U. PA. J. CONST. L. 215, 227 (2009).

35. U.C.C. § 9-601(a)(1) (1998) (establishing the rights of a creditor when a debtor defaults on the obligation including the right to peaceably repossess the collateral as a form of foreclosure).

36. For purposes of this Article, the term *startup* refers to a fledgling business enterprise.

37. Jeffrey A. Brill, "Testing the Waters"—*The SEC's Feet Go from Wet to Cold*, 83 CORNELL L. REV. 464, 467 (1998).

tors require a return on their investment.³⁸ Generally, the cost of venture capital (VC) is high.³⁹ Nevertheless, the high cost of VC does not account for the managerial benefits that experienced VCists provide.⁴⁰

Two common ways of measuring the return that investors require are Net Present Value (NPV) and Internal Rate of Return (IRR).⁴¹ Investors use NPV to determine the profitability of any business project.⁴² NPV is the difference between the present value of expected cash inflows and the present value of estimated cash outflows.⁴³ Such an analysis depends on a reliability of future cash flows that a business will yield.⁴⁴ In the case of a startup, such future cash flows may be difficult to predict, thus increasing the risk of the startup.⁴⁵ To offset and compensate for that risk, investors require a higher rate of return on their investment.⁴⁶

IRR is the discount rate that makes the NPV of all cash flows equal zero.⁴⁷ The higher a business's NPV, the higher the discount rate required to zero out NPV.⁴⁸ Therefore, when a startup has a high IRR, the startup attracts more investment.⁴⁹ Investors use IRR to rank potential ventures in order of prospective profitability.⁵⁰

38. Sophie Manigart et al., *Determinants of Required Return in Venture Capital Investments: A Five-Country Study*, 17 J. OF BUS. VENTURING 291 (2002) (discussing the return required by over 200 venture capital firms).

39. Fisch, *supra* note 2, at 62.

40. *Id.*

41. Carlton L. Dudley, Jr., *A Note on Reinvestment Assumptions in Choosing Between Net Present Value and Internal Rate of Return*, 27 J. FIN. 907 (1972) (discussing differences between NPV and IRR).

42. *Evaluating Cash Flows: NPV and IRR*, COLUMBIA.EDU, http://ci.columbia.edu/ci/premba_test/c0332/s5/s5_5.html (last visited Dec. 18, 2013).

43. *Id.*; see also Ronald E. Shrieves & John M. Wachowicz, *Free Cash Flow (FCF), Economic Value Added (EVA), and Net Present Value (NPV): A Reconciliation of Variations of Discounted-Cash-Flow (DCF) Valuation*, 46 ENGINEERING ECONOMIST 33, 35 (2001).

44. Dudley, *supra* note 41.

45. In the case of a startup, there is often a lack of data establishing a pattern or a trend that would assist in forecasting future cash flows.

46. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 262 (1958).

47. *See id.*

48. NPV is the preferred method of analysis of capital budgeting as NPV better represents expected shareholder value. The problem with IRR is that it assumes that a project will not produce any interim or intermediate cash flows, or if there are such cash flows, that those cash flows will be reinvested at the same IRR. If a project has a positive NPV, IRR will underestimate the return. If a project has a negative NPV, which is the more likely case, IRR will overestimate returns and cause investors to lose money. *See generally* John C. Kelleher & Justin J. MacCormack, *Internal Rate of Return: A Cautionary Tale*, MCKINSEY Q. (2005); Patricia A. Ryan & Glen P. Ryan, *Capital Budgeting Practices of the Fortune 1000: How Have Things Changed?*, 8 J. BUS. & MGT. 4 (Winter 2002); Dudley, *supra* note 41.

49. BRIGHAM & HOUSTON, *supra* note 4, at 373–76.

50. *Id.*

Compliance with the federal securities laws, rules, and regulations also attributes to the cost of equity investment. Once the entrepreneur obtains equity investment, the entrepreneur ceases to be sole proprietor. When an equity investor becomes a part owner of the startup that is not registered or organized under the laws of a jurisdiction, relevant jurisdictional partnership laws state that the owners formed a partnership.⁵¹ If the startup registers under the laws of its respective jurisdiction, the owners may choose to form a myriad of business organizations, including a limited liability company, a closely held corporation, or if the state has adopted a newer business entity under the guise of social enterprise legislation, a socially beneficial entity type such as a flexible purpose corporation, limited liability low-profit company, or certified benefit corporation.⁵² Nevertheless, the entrepreneur would be wise to organize and register with the state to obtain a liability shield to protect the entrepreneur's personal assets.⁵³

When registration occurs, or when the entrepreneur takes on equity investment, the entrepreneur leaves the world of state blue sky laws and enters the world of federal securities regulation. As discussed in Part III below, the ownership interest that an investor takes in a startup is a security.⁵⁴ The investor, any broker-dealer intermediary, and the startup must then take into account and comply with the federal laws, rules, and regulations that apply to securities, namely the Securities Act of 1933, the Securities Exchange Act of 1934, and the rules and regulations promulgated thereunder.⁵⁵ In addition to the laws, rules, and regulations of the 1933 Act and 1934 Act,⁵⁶ securities are subject to the various acts that Congress enacted since the 1930s such as the Sarbanes-Oxley Act, Dodd-Frank Act, and JOBS Act.⁵⁷ If investors, broker-dealers,⁵⁸ and startups, including the startups' directors, officers, and employees, do not comply with, or violate these laws, rules, and regulations, investors, broker-dealers, and startups

51. UNIF. P'SHIP ACT § 101(6) (1997).

52. See generally D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS, CASES, PROBLEMS, AND CASE STUDIES (3d. ed. 2012); David A. Groshoff, *Con-trapreneurship? Examining Social Enterprise Legislation's Feel-Good Governance Giveaways*, 16 U. PA. J. BUS. J. (forthcoming 2014).

53. SMITH & WILLIAMS, *supra* note 52, at 115, 221.

54. See generally 1933 Act, 15 U.S.C. § 77a (2012); 1934 Act, 15 U.S.C. § 77b (2012).

55. See generally 1933 Act; 1934 Act.

56. 1933 Act; 1934 Act.

57. Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act), Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of U.S.C. titles 11, 15, 18, 28, and 29); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S.C. titles 7, 12, 15, and 31).

58. Broker-dealers are defined by the 1933 Act as persons engaged in the business of effecting transactions in securities for the account of others. 15 U.S.C. § 77a. See also JAMES D. COX ET AL., SECURITIES REGULATION 1019 (6th ed. 2009).

face potential civil enforcement actions by the Securities and Exchange Commission (SEC) and lawsuits from private plaintiffs.⁵⁹

Securities law compliance has become even more difficult and therefore costly in the last eleven years with the passage of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010.⁶⁰ Capital market participants still do not know what the Dodd-Frank Act will bring, as the SEC is still implementing and promulgating rules under the Dodd-Frank Act.⁶¹ The entrepreneur typically is not going to be familiar with these securities laws and therefore must often hire an attorney who specializes in securities regulation to ensure compliance, and such attorneys are rather expensive.⁶²

2. Finding Investors

At some point, a startup requires outside equity financing to fund its operations.⁶³ A well-known source of outside financing is VC funding.⁶⁴ Though VC funds provide value to entrepreneurs, VC funds are not a major source of equity financing in the United States.⁶⁵ Venture capital funds typically restrict their investments to startups in “later stage[s] and larger deals.”⁶⁶ In addition, VC funds on average require a return of thirty percent or more, which can be quite expensive to the firm.⁶⁷

An earlier potential alternative to VC funding is the use of “angel” investors.⁶⁸ Angel investors are diverse wealthy private investors who invest in startup companies.⁶⁹ These angel investors collectively constitute the angel market.⁷⁰ Angels typically invest their own money unlike VC funds that invest other people’s money.⁷¹ The market for angel investors is inefficient, so finding angel investors can be difficult.⁷² The entrepreneur can perform an Internet search to locate such angel investors, but such a search is not very effective because private

59. COX ET AL., *supra* note 58.

60. *Id.* at 9.

61. *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act — Pending Action*, SEC.GOV (May 2, 2013), <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml>.

62. See, e.g., Vincent DiCarlo, *How Much Will FINRA (formerly known as NASD) Arbitration Cost?*, INVESTORRECOVERY.COM, <http://www.investorrecovery.com/HowMuchWillItCost.html> (last visited Aug. 23, 2013).

63. Orcutt, *supra* note 3, at 865.

64. *Id.*

65. *Id.*

66. *Id.* at 871.

67. Dharmesh Shah, *Fatal Distraction: The True Cost of Startup Capital*, ONSTARTUPS.COM (Mar. 22, 2006), <http://onstartups.com/tabid/3339/bid/196/Fatal-Distraction-The-True-Cost-Of-Venture-Capital.aspx>.

68. Orcutt, *supra* note 3, at 881.

69. *Id.* at 882.

70. *Id.* at 881.

71. *Id.* at 877.

72. *Id.*

investors do not advertise themselves as such on the Internet very often.⁷³ The most common way to find angel investors is to ask friends and family if they would be willing to invest in the startup or if they know of someone who would be willing to invest in the startup.⁷⁴

Once the entrepreneur finds individuals or funds willing to invest in the startup, the entrepreneur needs to ensure that the sale of equity fits one of the exemptions outlined in § 4 of the 1933 Act.⁷⁵ To meet the most important requirements of a § 4(2) private placement exemption, the entrepreneur must have a prior relationship with the investor and the investor must be sophisticated.⁷⁶ If no such relationship exists between the entrepreneur and the investor, the entrepreneur can seek an exemption under Rules 504, 505, or 506 of Regulation D.⁷⁷ Naturally, the entrepreneur should hire a securities attorney to ensure that the requirements for such exemptions are met.

C. A Brief History of Crowdfunding

The phenomenon of crowdfunding originated from the idea of crowd sourcing, which is “the idea that a [single] task may be delegated to a crowd.”⁷⁸ Just as a crowd of people could perform a task, a crowd of people can fund a project. Michael Sullivan coined the term “crowdfunding” in 2006, even though the phenomenon had existed since the early 1990s.⁷⁹ Crowdfunding began with charitable giving, and then was adapted for use of funding artistic projects of musicians and filmmakers.⁸⁰ Artistic projects would create a webpage on a domain known as a portal where supporters of the project could donate or pledge money. Crowdfunding became prominent and gained media attention in the last few years when websites such as Kickstarter.com and RocketHub.com began marketing crowdfunding as the premier method of raising capital.⁸¹

73. Geoff Williams, *Find Investors for Your Business: Need Some More Operating Cash? It's Time to Look for an Investor*, ENTRENEUR.COM (Oct. 18, 2006), <http://www.entrepreneur.com/article/169324>.

74. *Id.*

75. See generally 1933 Act § 4, 15 U.S.C. § 77a (2012). The SEC has exempted certain transactions such as the purely intrastate transaction, the purely private transaction that meets the *SEC v. Purina Ralston Co.* requirements, and transactions under Regulation D. See *infra* note 76.

76. See *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

77. 17 C.F.R. §§ 230.504–230.506 (2013). Regulation D excepts limited offerings in three situations: (§ 504) where the maximum aggregate offering price is \$1,000,000, (§ 505) where the maximum aggregate offering price is \$5,000,000 with no more than thirty-five purchasers, and (§ 506) where there is no maximum aggregate offering price but with only thirty-five non-Ralston accredited purchasers and no limit to the number of Ralston accredited purchasers.

78. Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS 63, 63 (2011).

79. *Id.* at 70–71.

80. *Id.* at 71.

81. *Id.*

III. IS CROWDFUNDING A SECURITY?

The 1933 Act and the rules and regulations promulgated thereunder apply to securities.⁸² The 1933 Act does not provide a definition of the word security. However, the 1933 Act gives examples of securities that fall within the 1933 Act's scope. The 1933 Act lists notes, stocks and bonds, profit sharing agreements, investment contracts, and instruments known as securities.⁸³ If equity crowdfunding creates one of these examples listed above, then the federal securities laws, rules, and regulations will apply to equity crowdfunding.

The most common test to determine whether crowdfunding falls within the scope of the federal securities laws, rules, and regulations is by an application of the test created by the United States Supreme Court in *SEC v. W.J. Howey Co.* relating to investment contracts.⁸⁴

In *Howey*, defendant sold parcels of citrus groves in Florida to equity investors.⁸⁵ Investors took no part in the cultivation and signed ten-year service agreements where Howey would cultivate and harvest the oranges and then pay investors according to the yield of the oranges.⁸⁶ The SEC sued Howey claiming that the service agreements acted as investment agreements and that Howey needed to register the investments under the 1933 Act.⁸⁷ The Court agreed with the SEC and stated that the 1933 and 1934 Acts apply when "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."⁸⁸

A. Application of the Howey Test

1. Investment of Money

Money can be invested either in the form of cash, or equivalents, such as negotiable instruments or chattel paper. In the case of equity crowdfunding, the crowd invests cash. However, to qualify as an investment, the crowd cannot receive or buy a consumable commodity or service. The current crowdfunding of artistic projects such as films and documentaries do not fall within the scope of the federal securities laws because supporters are essentially buying consumable commodities or services because the supporters receive the perquisites listed above. If only an equity interest is exchanged, then the Federal securities laws, rules, and regulations would apply because the entrepreneur would be issuing a security. Therefore, if an individual deliv-

82. See generally 1933 Act § 4, 15 U.S.C. § 77a-b (2012).

83. *Id.*

84. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 293 (1946).

85. *Id.* at 295.

86. *Id.* at 296.

87. *Id.* at 293-94.

88. *Id.* at 301.

ers cash to a business via a funding portal on the Internet in exchange for equity, there has been an investment of money.

2. Common Enterprise

A common enterprise exists when everyone's money has been pooled together.⁸⁹ The Fifth Circuit Court of Appeals stated in *SEC v. Koscot Interplanetary* that a common enterprise exists when there is either horizontal or vertical commonality.⁹⁰ Vertical commonality exists when there is a single investor, and the activities of the promoter are the controlling factor in the success or failure of the investment.⁹¹ Horizontal commonality exists when multiple investors have an inter-related interest in a common scheme.⁹² Equity crowdfunding most likely involves horizontal commonality rather than vertical commonality. In equity crowdfunding the multiple investors are the crowd, or the many supporters who fund the startup via an online portal, and the interrelated interest in a common scheme is the interest of making a return on an investment in the startup.

3. Expected Profits

The word profit is difficult to define. Neither did the Court in *Howey* attempt to define the word profit. However, in *Howey*, the investors were not buying oranges.⁹³ Rather, the investors were buying rights to the proceeds of the oranges less growing and production costs.⁹⁴ In an equity crowdfunding situation, the crowd is not buying the goods or services of the startup.⁹⁵ When the crowd buys consumable goods and services, the result is donation crowdfunding.⁹⁶ Rather, in an equity crowdfunding situation, the crowd buys rights to the proceeds less the costs of whatever goods and services the startup provides.

4. Derived Solely from the Efforts of Others

Profits that come solely from the efforts of others require that the profits come from the labor of people who are not the investors.⁹⁷ *Koscot Interplanetary* stated that the expected profits could come

89. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 887 (2011).

90. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974).

91. *COX ET AL.*, *supra* note 58, at 38.

92. *Id.* at 39.

93. *Howey*, 328 U.S. at 295.

94. *Id.*

95. Heminway & Hoffman, *supra* note 89, at 890.

96. Tanya Prive, *Crowdfunding: It's Not Just for Startups*, FORBES (Feb. 6, 2013 10:29 AM), <http://www.forbes.com/sites/tanyaprive/2013/02/06/crowdfunding-its-not-just-for-startups/>.

97. *Howey*, 328 U.S. at 300.

predominantly from the efforts of others.⁹⁸ Just as in *Howey* where *Howey* would perform the labor required to grow and sell citrus fruit for the enterprise, the startup would predominantly perform the labor required to provide the goods and services of the startup, and the crowd or equity owners would be entitled to the residual or profits.

Since equity crowdfunding involves the investment of money into a common enterprise where the crowd would expect profits solely (or predominantly) from the efforts of others, equity crowdfunding would most likely qualify as an investment contract and would be subject to the federal securities laws, rules, and regulations.

IV. COMPLIANCE WITH THE FEDERAL SECURITIES LAWS

Issuers⁹⁹ of securities must comply with the federal security laws, rules, and regulations or face civil liability to the SEC, individuals, or both.¹⁰⁰ Since equity crowdfunding most likely involves a security, startups that engage in equity crowdfunding must comply with federal securities laws, rules, and regulations. The major requirement of the 1933 Act is Section 5 registration.¹⁰¹ The policy behind registration is to protect investors by requiring issuers of securities to register with the SEC.¹⁰² By registering with the SEC, issuers disclose enough relevant information to investors to allow investors to make informed decisions on the risk involved and whether to purchase the security from the issuer.¹⁰³ This is achieved through a Section 5 (of the 1933 Act) registration statement.¹⁰⁴ Registration statements must meet the requirements of Regulation S-K and must precede an IPO.¹⁰⁵ An IPO is an initial sale of stock of a private company to the public with the assistance of an underwriter, and neither the transaction nor security is exempt under the federal securities laws.¹⁰⁶

Equity crowdfunding is similar to an IPO. When a startup sells ownership interest or stock via an online portal to the public for the first time, the startup essentially performs an IPO. Equity crowdfunding may even involve an underwriter.¹⁰⁷ The function of an underwriter in

98. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d. 473, 485 (5th Cir. 1974).

99. The 1933 Act defines issuers as “every person who issues or proposes to issue a security.” SMITH & WILLIAMS, *supra* note 52. For purposes of this Article, a startup that sells securities in an equity crowdfunding situation is an issuer because such startup issues or proposes to issue a security.

100. Warren Motley, Charles Jackson, Jr., & John Bernard, Jr., *Federal Regulation of Investment Companies Since 1940*, 63 HARV. L. REV. 1134, 1155 (1950).

101. Heminway & Hoffman, *supra* note 89, at 907.

102. COX ET AL., *supra* note 58, at 3.

103. *Id.*

104. Heminway & Hoffman, *supra* note 89, at 907.

105. *See, e.g.*, 17 C.F.R. § 229 (2013).

106. COX ET AL., *supra* note 58, at 115.

107. The 1933 Act defines an underwriter generally as any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation

an IPO is to find investors for the issuer.¹⁰⁸ The online portal, such as kickstarter.com or gofundme.com, does exactly that. Online portals help the startup find investors in the crowd just as an underwriter would in an IPO situation. Equity crowdfunding therefore has the appearance of an IPO that would ordinarily require registration with the SEC.

What saves crowdfunding from being an IPO is the JOBS Act.¹⁰⁹ Title III of the JOBS Act amends § 4 of the 1933 Act and adds an exemption for equity crowdfunding.¹¹⁰ A security or a security transaction is either exempt or not exempt from the securities laws, rules, and regulations.¹¹¹ Such classifications are binary.¹¹² The classic example of binary code is computer code. Computer code is either a one or a zero and therefore binary. Securities and securities transactions like binary code are either exempt or nonexempt.¹¹³ Exempt securities and transactions do not need to register with the SEC whereas non-exempt securities and transactions do need to register with the SEC.¹¹⁴

Title III of the JOBS Act exempts transactions involving the offer or sale of securities by an issuer provided that: (A) the aggregate amount sold to all investors does not exceed \$1,000,000 in a twelve-month period; (B) the aggregate amount sold to an investor with a net worth less than \$100,000 is \$2,000, and to an investor with a net worth equal to or more than \$100,000 is \$10,000; (C) the transaction is conducted through a broker or funding portal; and (D) the issuer complies with § 4A(b).¹¹⁵

If the annual income or net worth of an investor is less \$100,000, then the most that investor can invest is \$2,000.¹¹⁶ If the investor's annual income or net worth is equal to or more than \$100,000, the most that investor can invest is ten percent of the investor's annual income or total net worth, not to exceed an aggregate of \$100,000, or in basic terms, \$10,000.¹¹⁷ Equity crowdfunding is geared more towards the investor who would be limited to \$2,000.¹¹⁸ Not only is the

in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. *See, e.g., SMITH & WILLIAMS, supra* note 52.

108. COX ET AL., *supra* note 58, at 116.

109. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 302, 126 Stat. 306 (2012), *available at* <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

110. *Id.*

111. Dennis Stubblefield, (*Securities*) *Sellers Beware*, NORTH COUNTY LAWYER, Dec. 2010, at 8.

112. *Id.*

113. *Id.*

114. *Id.* at 14, 21.

115. *See* Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 302, 126 Stat. 306 (2012), *available at* <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

116. *Id.*

117. *Id.*

118. *See id.*

purpose of the JOBS Act to allow startups to access capital, but also to allow average Americans the opportunity to invest.¹¹⁹

The main differences between IPOs and equity crowdfunding are the maximum aggregate price of the offerings and the maximum aggregate price an investor can spend. When Facebook conducted its IPO in May 2012, Facebook raised an estimated \$16 billion.¹²⁰ The JOBS Act, however, limits the amount of money that can be raised by crowdfunding at \$1 million.¹²¹

One possible reason why Congress set this arbitrary and non-inflation-adjusted maximum aggregate offering price at \$1,000,000 is because of the potential for fraud.¹²² Since the JOBS Act exempts equity crowdfunding from fraud-preventing disclosures, a person could foreseeably create a startup, organize and create a funding campaign via an online portal, solicit \$1,000,000 from the crowd, and then fraudulently embezzle the money raised through the portal.¹²³

Nevertheless, though the JOBS Act does not exempt equity crowdfunding from Rule 10b-5, liability under § 10b of the 1934 Exchange Act prohibits any person from employing a deceptive scheme or making a material misstatement in connection with the sale or purchase of a security.¹²⁴ In addition, if a startup exceeds the limitations of the JOBS Act exemption, the startup would be subject to § 12(a)(1) liability of the 1933 Act.¹²⁵

V. SHORTCOMINGS OF THE JOBS ACT

A. *Potential for Fraud and Lack of Adequate Remedy*

Since the JOBS Act exemption limits the aggregate price of securities that an investor can purchase from a single startup in an equity crowdfunding situation to either \$2,000 or \$10,000, the most an investor can recover from the startup is either \$2,000 or \$10,000.¹²⁶ With

119. 158 CONG. REC. H1234-01 (daily ed. Mar. 7, 2012) (statement of Rep. Fincher).

120. Julianne Pepitone, *Facebook's IPO Price: \$38 Per Share*, CNNMONEY (May 17, 2012, 5:15 PM), <http://money.cnn.com/2012/05/17/technology/facebook-ipo-final-price>.

121. See Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 301, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

122. Thomas Lee Hazen, *Content: Social Networks and the Law: Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1756 (2012).

123. *Id.*

124. See SMITH & WILLIAMS, *supra* note 52; 1933 Act § 10(b), 15 U.S.C. 77j (2012).

125. See SMITH & WILLIAMS, *supra* note 52; 1933 Act § 10(b), 15 U.S.C. 77j.

126. *Randall v. Loftsgaarden*, 478 U.S. 647, 651–52 (1986) (The appropriate measure of damages in a securities fraud situation is recessionary damages. Recessionary damages retroactively rescind the securities transaction and award the investor the amount of money that the investor spent in the transaction.).

such low dollar amounts, a 10b-5 or 12a private action might not make an aggrieved investor whole.

If an investor's annual income is more than \$100,000, and the investor is capable of spending \$10,000 on a crowdfunding campaign, that investor theoretically qualifies as a sophisticated *Ralston* investor and such transaction would be exempt under § 4(2) of the 1933 Act.¹²⁷ Nevertheless, if an investor invests \$2,000 to \$10,000, and the entrepreneur fraudulently steals that money, the investor has lost only \$2,000 to \$10,000.¹²⁸

Choosing to sue the entrepreneur and the startup resembles an investment decision because so much involves economics.¹²⁹ If the costs of the lawsuit exceed the anticipated recovery, then bringing the lawsuit would be pointless. In California, many of these suits would have to be tried in either small claims courts, where all claims of \$5,000 or less must be tried, or in limited jurisdiction courts, where all claims of \$15,000 or less must be tried.¹³⁰ Despite being in small claims courts, an aggrieved investor would likely still need the assistance of an attorney, because a 10b-5 suit is complicated.¹³¹ If the Court can barely tell when reliance is presumed, how can a small claims court officer tell?

Even though the filing fees for such small claims in California range from \$75 to \$175,¹³² filing fees plus the opportunity cost of time spent litigating the claim,¹³³ and the cost of hiring a securities attorney to assist the aggrieved investor would exceed the potential recovery of \$2,000.¹³⁴

127. See Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 301, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

128. In the grand scheme of investing in the world of securities, \$2,000 to \$10,000 is a drop in the bucket not worth getting out of bed, according to fashion model Linda Evangelista. See SEARCHQUOTES.COM [http://www.searchquotes.com/quotation/I_don%27t_get_out_of_bed_for_less_than_\\$10,000_a_day./111490/](http://www.searchquotes.com/quotation/I_don%27t_get_out_of_bed_for_less_than_$10,000_a_day./111490/) (last visited May 16, 2013).

129. Charles R. P. Pouncy, *The Rational Rogue: Neoclassical Economic Ideology in the Regulation of the Financial Professional*, 26 VT. L. REV. 263, 272 (2002) (describing an economic decision).

130. *Basic Considerations and Questions*, CAL. DEP'T OF CONSUMER AFFAIRS, http://www.dca.ca.gov/publications/small_claims/basic_info.shtml (last visited May 16, 2013).

131. The aggrieved investor theoretically could be a securities attorney and could therefore rely on the investor's own knowledge and experience in trying such a suit and would avoid the costs of hiring a securities attorney.

132. See *infra* note 136 and accompanying text.

133. John W. Payne, James R. Bettman & Mary Frances Luce, *When Time is Money: Decision Behavior under Opportunity-Cost Time Pressure*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 131 (1996). Opportunity cost is the value of the next-highest valued alternative of using a resource. *Id.* Commonly, opportunity cost is the value a person loses by doing one activity instead of another. *Id.* The opportunity cost of suing in small claims court is the value lost by spending time suing instead of working one's profession. *Id.*

134. Commonly, claimants' attorneys are typically commission-based and charge on average 33% of the award. Alternatively, securities attorneys have been known to

If the issuer is able to obtain Financial Industry Regulatory Authority (FINRA) jurisdiction and compel arbitration, such suits may be even less desirable.¹³⁵ The filing fees for a \$2,000 claim in FINRA arbitration are \$75.¹³⁶ For a \$10,000 claim, the filing fee is \$325.¹³⁷ If the aggrieved investor seeks punitive damages, the filings fees increase as the amount requested increases.¹³⁸

Alternatively, the crowd could pursue a class action. Class actions benefit the attorneys handling the case more than the plaintiffs. Class actions take a long time. Investors would receive less money than by bringing the claim on the investor's own behalf, but it is better than receiving nothing at all.

If an aggrieved investor pursues such actions and wins, the investor may potentially lose money. Therefore, it is better economically not to bring such suits. Without a threat of potential lawsuits, faux entrepreneurs would be less dissuaded from engaging in crowdfunding fraud.

B. *JOBS Act Repeats an Existing Exemption*

Congress's creation of this exemption is curious since the SEC adopted a similar exemption in the form of Rule 504 of Regulation D during the early 1980s to expand an issuer's ability to make private placements.¹³⁹ Rule 504 creates an exemption for transactions that have a maximum aggregate offering price of \$1,000,000.¹⁴⁰ Additionally, Rule 504 does not have a limit on the number of purchasers, does not impose affirmative disclosure obligations on the issuer, and restricts the resale of Rule 504 securities.¹⁴¹

The JOBS Act exemption also has a maximum aggregate offering price of \$1,000,000, does not have a limit on the number of purchasers, does not impose affirmative disclosure obligations, and restricts the

charge an hourly fee ranging from \$400 to \$800. *See, e.g., Guide to Finding Securities Lawyer*, LAWS.COM, <http://lawyer.laws.com/securities-lawyer> (last visited Nov. 9, 2013).

135. The Financial Industry Regulatory Authority is a self-regulatory organization that regulates securities firms in the United States. All broker-dealers must register with FINRA and agree to FINRA arbitration. *See About FINRA*, FINANCIAL INDUSTRY REGULATORY AUTHORITY, <http://www.finra.org/AboutFINRA/> (last visited May 16, 2013). *See also* Dennis Stubblefield, *The Nuts and Bolts of Customer Stockbroker Arbitration*, ORANGE CNTY. LAW. MAG., Dec. 2009, at 13.

136. *FINRA Arbitration Fees Calculator*, FINRA, <http://apps.finra.org/ARbitrationMediation/ArbFeeCalc/1/Default.aspx> (select "Customer," and enter today's date, and select "Next"; select "No," and enter the damages requested, and select "Next") (last visited Jan. 9, 2014).

137. *Id.*

138. *Id.*

139. 17 C.F.R. § 230.504 (2013).

140. *Id.*

141. *Id.*

resale of securities.¹⁴² The JOBS Act appears to be somewhat redundant. The fact that Congress created a new exemption indicates that existing exemptions were ineffective as to achieving Congress's goal of allowing startups easier access to equity financing. If existing exemptions were ineffective, then Congress should have created a new exemption that does not mirror an existing ineffective exemption.

C. *\$1,000,000 Limitation Is Too Low*

The \$1,000,000 limitation may not allow startups to raise capital sufficient to finance the startup's operations. In addition, startups often have the potential to attract more than \$1,000,000 in equity investment. Game console developer Ouya raised \$950,000 in its first eight hours on kickstarter.com.¹⁴³ And after the first month, Ouya raised approximately \$8.6 million.¹⁴⁴ Ouya's campaign involved funding in exchange for consumable goods and services. Imagine how much more investment Ouya could have raised if it was allowed to offer securities!

Along the same lines, a startup would likely not choose to limit itself to \$1,000,000 in equity crowdfunding when there is the option of crowdfunding in exchange for consumable goods or services. In the latter situation, the startup would incur costs of providing those goods and services, but those costs would easily be covered by the crowdfunding campaign and the startup could raise an unlimited amount. In the former situation, the startup would have to answer to as many as 500 owners, if not more,¹⁴⁵ as well as worry about fiduciary duties, dividends, annual stockholder meetings, and so much more. Further, the startup could seek investors under a Rule 505 or 506 exemption under Regulation D and potentially raise more than \$1,000,000.¹⁴⁶

142. See Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-116, § 301, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

143. Emmanuel, *supra* note 19.

144. *OUYA: A New One of a Kind Video Game Console*, KICKSTARTER.COM, <http://www.kickstarter.com/projects/ouya/ouya-a-new-kind-of-video-game-console> (last visited May 16, 2013).

145. If an equity crowdfunding campaign reaches the maximum aggregate of \$1,000,000, the fewest number of investors possible is 100 assuming each investor purchased \$10,000 worth of securities. If each investor purchased \$2,000, then the number of investors would be 500. Theoretically, a startup issuer could sell securities in an equity crowdfunding situation and have as many as 1,000,000 investors.

146. 505-exempt transactions are limited to an aggregate offering price of \$5,000,000 and 506-exempt transactions do not have a limit. 17 C.F.R. §§ 230.504–230.506 (2008).

D. *Increased Cost of Compliance*

Others have criticized the JOBS Act as increasing how much money a startup would have to expend on compliance.¹⁴⁷ While hopeful securities lawyers may enjoy the JOBS Act's demands, aspiring business people may cringe while thinking about how much the cost of compliance with the JOBS Act would be, because the startup would have to maintain records of the new investors and make sure that the startup maintains an exempt status. Nonetheless, entrepreneurs ready to launch an equity crowdfunding campaign may be willing to pay a securities attorney to ensure compliance if doing so meant being able to raise a significant amount of money.

VI. POTENTIAL CHANGES TO THE JOBS ACT THAT WOULD IMPROVE EQUITY CROWDFUNDING WHILE PRESERVING INVESTOR PROTECTION

Perhaps Congress could reexamine the equity crowdfunding exemption and ask itself, "What should I do?"¹⁴⁸ One option is to either increase or eliminate the maximum aggregate amount that can be raised in an equity crowdfunding situation and the amount that an individual investor can invest. The problem with raising or eliminating the limit is that doing so exposes investors to greater risk in case of fraud.¹⁴⁹ However, disclosure requirements easily offset the increase in risk exposure. Congress could do what Congress has been doing since the 1933 Act and impose disclosure requirements on equity crowdfunding. By making certain disclosures, investors would be better able to analyze the risk involved in purchasing a security and decide for themselves whether to purchase that security.

Further, disclosure requirements would deter the contreprenuer.¹⁵⁰ The contreprenuer (or wantreprenuer) would have to exert more effort in creating not just a fake business entity, but fake financials and fake disclosures that appeared real enough to persuade a potential investor that not only is the startup real, but that the investor should invest in the startup. Such disclosure requirements would increase costs for the startup, but would be balanced by the benefits provided to the investor in the form of investor protection.

147. See Emmanuel, *supra* note 19.

148. When four-time National Basketball Association Most Valuable Player LeBron James decided to leave his home state of Ohio and the state's loyal fans to join a competing team in Miami for greater potential rewards, James achieved a stunt with his new teammates on live television that offended many of his fans and painted himself in an unflattering light. Attempting to win back fans lost after the debacle, James recorded a series of commercials for his sponsor, Nike, in which James walked about cluelessly and asked foolishly, "What should I do?"

149. See Hazen, *supra* note 122, at 1762.

150. See Groshoff, *supra* note 52.

Another option would be to place third-party liability on the online portal, but this scenario is unlikely to be a viable option, since the SEC stated in a no-action letter that online portals are not broker-dealers.¹⁵¹ Online portals mainly create a place for startups to advertise and process the crowdfunding transactions.¹⁵² One of the biggest roles of an underwriter during an IPO is to set the initial price of the security.¹⁵³ In a crowdfunding situation, the market would determine the price of the security. If portals are not involved in the substance of the transaction, then it does not make sense to impose liability on someone who merely acts as an intermediary.

Nevertheless, Congress is not limited by the rules of the SEC. Congress could require online portals to perform due diligence investigations to ensure that the startup is legitimate. Therefore, if the portal does not investigate the startup, and fraud occurs, then investors could sue the portal for not ensuring that the startup was legitimate.¹⁵⁴ This example, too, would likely increase costs on the startup, as the portal would have to expend more of its resources on a crowdfunding campaign, and the portal would likely pass those costs on to the startup as a barrier to starting a crowdfunding campaign.

Additionally, Congress could require startups to obtain business insurance as a condition precedent to operating a crowdfunding campaign. If the startup then engages in fraud, a third-party insurance company would indemnify the startup. Again, an insurance requirement would place more costs on the startup.

Another option is to require some kind of accreditation or certification that the startup is real and has a legitimate purpose and business operation. Congress has plenary power in deciding what the accrediting or certifying agency could be. A government agency such as the SEC could investigate and research the startups, or perhaps more efficiently, Congress could delegate that authority to private enterprise. Even still, if a startup were to be required to obtain certification that the startup is real, then the startup would incur even more costs for obtaining such certifications. Nevertheless, investors could be certain that the startup is legitimate and would have to worry about only the merits of the transaction.

As a result, each of these alternatives to creating more protections for investors have a common element, increased costs on the startup. This idea seems counterintuitive, since the purpose of the JOBS Act is to make access to capital cheaper and easier for startups. Neverthe-

151. Steve Quinlivan, *SEC Says Crowdfunding VC Site Not a Broker Dealer*, DODD-FRANK.COM, http://dodd-frank.com/sec-says-crowdfunding-vc-site-not-a-broker-dealer/?goback=.gde_1039587_member_227132374 (last visited May 16, 2013).

152. *Id.*

153. COX ET AL., *supra* note 58, at 125.

154. One could likely frame this type of claim as negligence, in which the portal has a duty to investigate and could be liable for breaching that duty by not investigating pursuant to that duty.

less, the increased costs on the startup could be outweighed by the opportunity to raise a substantial amount of money.

VII. CONCLUSION

Since the SEC still has not implemented nor promulgated rules for the JOBS Act,¹⁵⁵ equity crowdfunding is still subject to § 12 of the 1933 Act liability.¹⁵⁶ Even when the SEC does implement rules under the JOBS Act for equity crowdfunding, an equity crowdfunding campaign would be pointless because of the potential failures of the JOBS Act. Congress's purpose of the JOBS Act was to make equity crowdfunding legal, which Congress made happen, but Congress did not quite realize its purpose.¹⁵⁷

Traditional IPOs appear to be dying a long, slow death for several reasons.¹⁵⁸ One cause of this decline is the high cost of IPOs.¹⁵⁹ Not only must a business comply with the 1933 Act with detailed precision to perform an IPO, that business must hire underwriters to execute the transaction. The cost of going public averages around ten percent of the gross proceeds.¹⁶⁰ Kickstarter.com, however, charges a flat 5% if the project is funded.¹⁶¹ A 5% difference that involves millions of dollars may represent material amounts to investors, web portals, and companies seeking financing. Not only is crowdfunding cheaper to the startup, it takes less time than a traditional IPO.¹⁶²

Equity crowdfunding is essentially a small scale IPO. Because IPOs will inevitably cease to exist, something must take the place of the IPO as a means of issuing securities to the public. This Article proposes that equity crowdfunding fill that gap. Through equity crowdfunding, businesses—whether small startups or private companies ready to make the plunge into the public—would be able to raise as much capital as necessary, and investors would be able purchase as many shares as the public wants. Congress passed, and President Franklin Delano Roosevelt signed, the 1933 Act in an era where offers to purchase or sell a security were done in person, by telephone, or through U.S. mail. In the last eighty years, the landscape of the world has changed materially and has brought with it a change in the landscape of equity securities.

As evidenced throughout this Article, the new world of raising equity capital via web platforms no longer needs traditional underwrit-

155. See Quinlivan, *supra* note 151.

156. See 1933 Act § 12, 15 U.S.C. 771(a) (2012).

157. Emmanuel, *supra* note 19.

158. Heminway & Hoffman, *supra* note 89, at 907.

159. Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPRENEURIAL BUS. L.J. 369, 370 (2007).

160. *Id.* at 372.

161. KICKSTARTER.COM, <http://www.kickstarter.com/start> (last visited Dec. 16, 2013).

162. See generally COX ET AL., *supra* note 58, at 158–82.

ers. Instead, investors and businesses can access materially more relevant information via the Internet today than was available to institutional investors only fifteen years ago. When Facebook announced its per share price of \$38 for its IPO, many pundits stated that that price was too high and predicted that the price would drop after initial sales.¹⁶³

These prognosticators were able to make such informed predictions due to the wealth of information available on the Internet. Investors can rely on the market and available information when deciding whether to purchase a security. Once the investing world realizes that the investing world can rely on the market and the wealth of information available on the Internet, the investing world will stop employing the large investment banks. Because crowdfunding portals could perform essentially the same function as underwriters for less money, they may well take the underwriters' jobs, thanks to the JOBS Act. Because online portal funding sites may someday replace investment banks as the intermediary between issuers and investors due to equity crowdfunding, Morgan Stanley employees may have to someday declare, as once heralded in an episode of the Comedy Central network's cartoon show, *South Park*, "Crowdfunding took our jerbs!"¹⁶⁴

163. Pepitone, *supra* note 120; Robert Leclerc, *Overvaluing Facebook*, FINANCIAL POST (June 6, 2012, 9:05 PM), <http://opinion.financialpost.com/2012/06/06/overvaluing-facebook/>.

164. The phrase, "They took our jerbs" emanates from a comedic television program in which various characters lost their jobs to individuals who were willing to do the same work for less money. See *Southpark: Goobacks* (Comedy Central television broadcast Apr. 28, 2004). For information on how crowdfunding could potentially affect venture capitalists, see *How Crowdfund Investing Will Impact the Venture Capital and Broker Dealer Community*, RESEARCHANDMARKETS (Aug. 2013) (webinar), available at <http://www.researchandmarkets.com/reports/2500780/>.